N. IRC 514 - UNRELATED DEBT-FINANCED INCOME

1. Introduction

IRC 514, as it exists today, expands "unrelated business income" to include "unrelated debt-financed income" from investment property in proportion to the debt acquired in purchasing it. Property purchased with borrowed money (an "acquisition indebtedness") and held to produce investment income is called "debt-financed property." Basically, due to the provisions of IRC 512(b)(4), IRC 514 taxes income that would be otherwise excluded from taxation under IRC 512(b)(1), (b)(2), (b)(3), and (b)(5) (for example, dividends, interest, royalties, rents, and certain gains or losses from the sale of property), but only if two conditions are met: (1) the income arises from property acquired or improved with borrowed funds, and (2) the production of income is unrelated to the purpose constituting the basis of the organization's tax exemption.

The necessity for IRC 514 arose because a large number of tax-exempt organizations bought businesses and investments on credit, frequently at what was more than the market price, while contributing little or nothing themselves to the transaction other than their tax exemption. In a typical situation, a corporate business was sold to an IRC 501(c)(3) organization, which made a small down payment, or none at all, and agreed to pay the balance of the purchase price out of profits from the property. The exempt organization liquidated the corporation, and leased the business assets back to the seller, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as "rent" to the exempt organization, which then paid most of these receipts back to the original owner as installment payments on the original purchase price. In the well-known Clay Brown case (Clay B. Brown and Dorothy E. Brown v. Commissioner, 325 F.2d 313 (1963), aff'd 380 U.S. 513 (1965)), a business was able to realize after-tax income, and the exempt organization acquired the ownership of a business valued at $1.3 million without the investment of its own funds. (The tax results of this transaction under pre-1969 law provided a capital gain to the seller, a rent deduction for the operator, and no tax on the tax-exempt organization.)

Before considering how to compute an organization's unrelated debt-financed income, the terms "debt-financed property" and "acquisition indebtedness" must be defined.

2. Debt-Financed Property

A. General Rule

"Debt-financed property" means, with certain exceptions, any property (e.g., rental real estate, tangible personal property, corporate stock), held to produce income (e.g., interest, dividends, royalties, rents, capital gains), and with respect to which there is "acquisition indebtedness" at any time during the taxable year. See IRC 514(b)(1). "Debt-financed property" has been held to include mineral production payments purchased with borrowed funds (Rev. Rul. 76-354, 1976-2 C.B. 179), and a partnership interest (Rev. Rul. 74-197, 1974-1 C.B. 143).

The specific exceptions to the term "debt-financed property" will be discussed below.

B. Specific Exceptions

(1) At Least 85 Percent of Property's Use Is Related to Exempt Purposes

Property, where substantially all (at least 85 percent) of its use is substantially related to exempt purposes, is not treated as "debt-financed property." See IRC 514(b)(1)(A). An example of this exception involved an organization created by an IRC 501(c)(6) Chamber of Commerce to encourage business development in a community. The organization obtained a mortgage to help finance the construction of a building leased to an industrial tenant at less than full rental value. The leasing of the property was not unrelated trade or business as defined in IRC 513 because it was substantially related to the organization's exempt purpose. See Rev. Rul. 81-138, 1981-1 C.B. 358; see also Rev. Rul. 69-464, 1969-2 C.B. 132.

Whether this exception applies is determined by applying the rules of IRC 513 and the underlying regulations, so that cases where this exception is at issue are, in essence, IRC 513 cases. An example of a case in which the Service found the exception did not apply involved an IRC 501(c)(3) historical preservation association that acquired, restored, and preserved buildings of historical and/or architectural significance and opened the restored buildings to the public for a nominal admission fee. The organization acquired certain other historically or architecturally significant buildings by assumption of outstanding mortgages and leased them at fair rental value (subject to a covenant to insure that the architectural features of the buildings were maintained by the lessees) for uses that bore no relationship to the building's historical or architectural significance and did not allow for viewing by the general public. Because this leasing did not contribute importantly to the organization's exempt purpose and had no causal relationship to the achievement of that purpose, the exception under IRC 514(b)(1)(A) did not apply and the leased buildings were held to constitute debt-financed property. See Rev. Rul. 77-47, 1977-1 C.B. 157.

In Elliot Knitwear Profit Sharing Plan v. Commissioner of Internal Revenue, 614 F.2d 347 (3rd Cir. 1980), an employee profit-sharing plan that was exempt from tax under IRC 501(a) (because it qualified under IRC 401(a)) purchased securities on margin. The court held that the securities purchased on margin constituted debt-financed property and that the profits derived from the sale were taxable as unrelated business income since the purchase of securities on margin is not inherent to the purpose of an exempt profit-sharing plan. Therefore, such purchases were held not to be excepted from the definition of debt-financed property.

It must be noted that if less than 85 percent of the use of any property is devoted to an organization's exempt purposes, only that portion of the property that is used in furtherance of an organization's exempt purposes is not treated as debt-financed property. See Reg. 1.514(b)-1(b)(1). For an example of a computation under IRC 514 involving a building purchased with borrowed funds that was used for both exempt and nonexempt purposes see (40)21(5) of IRM 7751.

(2) Property Producing Income That Is Otherwise Taxable Under IRC 511-513

Property, to the extent that it produces income under the general definition of unrelated trade or business, is not treated as "debt-financed property." See IRC 514(b)(1)(B).

Congress intended that income under the general definition of unrelated trade or business be taxable in its entirety. Therefore, IRC 514(b)(1)(B) was included in the statute; otherwise, such income, if derived from debt-financed property, might be taxable only to the extent of the outstanding indebtedness on the property.

Thus, IRC 514 does not apply to rents from personal property or, in the main, to passive income from controlled organizations described in IRC 512(b)(13). If passive income is taxable under both IRC 512(b)(13) (as income from a controlled organization) and IRC 514 (unrelated as debt-financed income), first make the computation under IRC 512(b)(13), then make the computation under IRC 514. See Example (3) of Reg. 1.514(b)-1(b)(3), set forth in Topic E of this CPE.

(3) <u>Property Producing Research Income Described in IRC 512(b)(7), (8), or (9)</u>

Property, to the extent it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax by IRC 512(b)(7), (8), or (9), is not treated as "debt-financed property." See IRC 514(b)(1)(C).

(4) <u>Property Producing Income Derived from an Activity Excepted from the Definition of Unrelated Trade or Business by IRC 513(a)(1), (2), or (3)</u>

Property that produces income from an activity excluded from the definition of "unrelated trade or business" under IRC 513(a)(1), (2), or (3) (because substantially all the work is performed without compensation; because the business is carried on primarily for the convenience of members, students, patients, officers, or employees; or because the business involves the selling of merchandise, substantially all of which was received as gifts or contributions), is not treated as "debt-financed property." See IRC 514(b)(1)(D).

(5) <u>Exceptions (1), (3), and (4) Made Applicable to Property Owned by an Exempt Organization and Used by a Related Organization (Related Use Exception)</u>

Property owned by an exempt organization and used by a related exempt organization (or by an exempt organization related to the related exempt organization), is not treated as "debt-financed property" to the extent the property is used by either organization in furtherance of its exempt purposes, for research activities described in IRC 512(b)(7), (8), or (9), or in activities described in IRC 513(a)(1), (2), or (3). See IRC 514(b)(2).

In essence, IRC 514(b)(2) extends the provisions of IRC 514(b)(1)(A), (C), and (D) (Exceptions 1, 3, and 4, above), to cases where related exempt organizations are involved. Reg. 1.514-(b)1(c)(2)(ii) provides that for purposes of this provision an exempt organization is related to another exempt organization only if --

(a) one organization is an exempt title-holding company described in IRC 501(c)(2) and the other derives profits from such exempt title-holding company,

(b) one organization has control of the other within the meaning of Reg. 1.512(b)-1(1)(4) (see Topic E of this CPE for a thorough discussion of "controlled organizations"),

(c) more than 50 percent of the members of one organization are members of the other, or

(d) each organization is a local organization directly affiliated with a common state, national, or international organization that is also exempt.

Reg. 1.514(b)-1(c)(2)(iii) gives four examples where the relatedness of organizations is at issue.

(6) Medical Clinic Exception.

Real property leased to a medical clinic, where the lease is entered into primarily for the exempt purposes of the lessor, is not treated as "debt-financed property." See IRC 514(b)(1).

For example, assume that an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received are not unrelated debt-financed income.

(7) "Life Income Contract" Exception

Property transferred by an individual to a trust or a fund subject to a "life income contract" described in Reg. 1.514(b)-1(c)(3) is not treated as "debt-financed property." The essential elements of a "life income contract" are --

(a) The individual must transfer property to a trust or a fund subject to a contract providing that the income is to be paid to that individual or to other individuals (or to both) for a period of time not to exceed the life of the individual or individuals;

(b) the transaction must be one in which payments to the individual do not constitute the proceeds of a sale or exchange of the transferred property; and

(c) the remainder interest must be payable to an exempt organization described in IRC 501(c)(3).

Reg. 1.514(b)-(1)(c)(3)(ii) gives the following illustration of the "life income contract" exception:

> On January 1, 1967, A transfers property to X, an exempt organization described in section 501(c)(3), which immediately places the property in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him to a proportionate part of the fund's income for his life and for the life of another individual. None of the payments made by X are treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X from A is treated as debt-financed property.

(8) <u>The "Neighborhood Land Rule" Exception</u>

The "neighborhood land rule" provides that if an organization acquires real property and intends to use it for exempt purposes (within 10 years), the property will not be treated as "debt-financed property" if it is in the neighborhood of other property used by the organization for exempt purposes and the intent to use the property for exempt purposes (within 10 years) is not abandoned. See IRC 514(b)(3)(A). Churches and conventions or associations of churches operate under a somewhat liberalized version of the "neighborhood land rule." See IRC

514(b)(3)(E). One important requirement eliminates much property from this exception. IRC 514(b)(3)(C)(i) eliminates use of the rule for any structure that is on the land when acquired and that is not required to be removed or demolished as part of the conversion.

Property is considered in the "neighborhood" of property owned and used by an organization for its exempt purposes if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream or similar property. If the acquired property is not contiguous with the exempt function property, it may still be in the "neighborhood" of such property if it is within one mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. As an example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size is a block away from the campus. Under the circumstances, the contiguity requirement is unreasonable and the land purchased would be "neighborhood land." See Reg. 1.514(b)-1(d)(l)(ii).

If the property meets the requirements of IRC 514(b)(3), it is automatically entitled to the benefit of advance nontax treatment for the years after the date of acquisition. At least 90 days prior to the end of the 5th year, the organization must request a ruling to continue the benefits of the neighborhood land rule for another five years. The organization does not need to show binding contracts in satisfying this requirement but must have a definite plan detailing a specific improvement and a completion date, and show some affirmative action toward fulfillment of the plan. See Reg. 1.514(b)-1(d)(l)(iii).

In addition, there is an "actual use rule." If the "neighborhood land rule" is inapplicable because the acquired land is not in the neighborhood of other land used for exempt purposes or because the organization is unable to establish after the first five years that the property will be used for exempt purposes, but the land is eventually used for exempt purposes within the 10 year period, such property is not treated as "debt-financed property" for any period prior to such conversion. See Reg. 514(b)-1(d)(2). Because of the initial inapplicability of the neighborhood land rule, the organization, of course, could not avail itself of advance nontax treatment prior to conversion; however, a refund of taxes is allowed in accordance with IRC 514(b)(3) and Reg. 1.514(b)-1(d)(4). Reg. 1.514(b)-1(d)(4)(ii) illustrates the mechanics of these provisions by the following example:

Y, a calendar year exempt organization, acquires real property in January 1970, which is contiguous with all the property used by Y in furtherance of its exempt purpose. However, Y does not satisfy the Commissioner by January 1975, that the existing structure will be demolished and the land will be used in furtherance of its exempt purpose. In accordance with this subparagraph, from 1975 until the property is converted to an exempt use, the income derived from such property shall be subject to the tax on unrelated business income. During July 1979, Y demolishes the existing structure on the land and begins using the land in furtherance of its exempt purpose. At this time Y may file claims for refund for the open years 1976 through 1978. Further, in accordance with this subparagraph, Y may also file a claim for refund for 1975, even though a claim for such taxable year may be barred by the statute of limitations, provided such claim is filed before the close of 1980.

The limitation that requires demolition or removal of existing structures, the special rule for churches and associations or conventions of churches, and a final note on "business leases" will be set forth below.

(a) Requirement of Demolition or Removal

The "neighborhood land rule" applies with respect to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land requires that the structure be demolished or removed in order to use the land for exempt purposes. Thus, during the first five years after the acquisition (and for subsequent years if there is a favorable ruling in accordance with IRC 514(b)(3)), improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Reg. 1.514(b)-1(d)(3)(i)(a) provides that if there is an actual demolition of such structures, the use made of the land need not be the one originally intended. Therefore, the "actual use" requirement may be satisfied by using the land in any manner that furthers the exempt purpose of the organization. Reg. 1.514(b)-1(d)(3)(i)(b) furnishes the following examples:

Example (1). An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first four years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under the circumstances, such property is not debt-financed property for the first four years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of the property is subject to section 514.

Example (2). Assume the facts as stated in Example (1) except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after the acquisition when it sells the property. Assume further that the university did not receive a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is debt-financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first five years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Example (4). (1) Assume that a university acquires a contiguous tract of land containing an office building for the principal purpose of demolishing the office building and building a modern dormitory. Five years later the dormitory has not been constructed, and the university has failed to satisfy the Commissioner that the office building will be demolished and the land will be used in furtherance of its exempt purpose (and consequently has failed to obtain a favorable ruling under subparagraph (1)(iii) of this paragraph). In the ninth taxable year after acquisition the university converts the office building into an administration building. Under these circumstances, during the sixth, seventh, and eighth years after acquisition, the office building is treated as debt-financed property because the office building was not demolished or removed. Therefore, the income derived from such property during these years shall be subject to the tax on unrelated business income.

(2) Assume that instead of converting the office building to an administration building, the university demolishes the office building in the ninth taxable year after acquisition and then constructs a new administration building. Under these circumstances, the land would not be considered debt-financed property for any period following the acquisition, and the university would be entitled to a refund of taxes paid on the income derived from such property for the sixth through eight taxable years after the acquisition. . .

(b) Special Rule for Churches

As noted above, IRC 514(b)(3)(C) sets forth a somewhat more liberal version of the "neighborhood land rule" for churches and conventions or associations of churches. First, instead of a 10 year period, a 15 year period applies. Churches and conventions or associations of churches are required to apply for a ruling to continue to receive the benefit after five years, but a favorable ruling covers another 10 years. Second, there is no requirement that the acquired land be in the neighborhood of other property used by the organization for exempt purposes.

(c) "Business Leases"

An organization cannot use the "neighborhood land rule" to escape taxation if the income from the property would have been subject to taxation under IRC 514 as it existed prior to amendment in 1969 (IRC 514(b)(3)(C)(iii)). IRC 514 at that time covered property that was subject to a "business lease." The "business lease" provisions are no longer contained in IRC 514. They can now be found in Reg. 1.514(f)-1 and 1.514(g)-1.

C. Special Problems Relating to Debt-Financed Property Under IRC 514(d) and (e)

(1) Basis of Debt-Financed Property Acquired in Corporate Liquidation (IRC 514(d))

Under IRC 514(d), if debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property is the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain which is includible, on account of such distribution, in the gross income of the organization as unrelated debt-financed income.

(2) Allocation Rules Under IRC 514(e)

IRC 514(e) provides that where only a portion of property is debt-financed property, proper allocation of the basis, indebtedness, income and deduction must be made to determine the amount of income or gain derived from such property which is to be treated as unrelated debt-financed income.

3. Acquisition Indebtedness

A. In General

For purposes of identifying debt-financed property, "acquisition indebtedness" is defined as the outstanding amount of an indebtedness incurred before, during, or after that acquisition or improvement. In the case of indebtedness incurred "before" or "after," acquisition indebtedness exists only if the indebtedness would not have been incurred but for such acquisition or improvement. In addition, in the case of indebtedness incurred after the acquisition or improvement of property, "acquisition indebtedness" exists only if the resulting indebtedness was reasonably foreseeable when the property was acquired or improved. See Reg. 1.514(c)-1(a)(1).

According to Reg. 1.514(c)-1(a)(1), whether indebtedness is reasonably foreseeable depends on all the facts and circumstances of each situation. The regulation further provides that actual foresight is not the test: although the need for the incurrence of an indebtedness may not have been actually foreseen by the organization, a subsequent incurrence of indebtedness may have been reasonably foreseeable. Text (41)12 of IRM 7751 sets forth four examples of situations where the issue is whether the incurrence of indebtedness was reasonably foreseeable. These examples are taken from Reg. 1.514(c)-1(a)(2).

> Example 1 in the IRM (example 2 in the regulation), involves an organization which used working capital that would be needed to carry out its exempt purposes to remodel an office building that was held to produce rent. The office building became debt-financed property when the organization borrowed funds at a later time to replace the working capital.

> A more detailed illustration is provided by example 2 in the IRM (example 3 in the regulation). There, an exempt school sold a classroom building to an organization that it did not control. The school took back a purchase money mortgage of $2 million to help finance the sale to the purchaser. At the time the purchase money mortgage was acquired, the school was aware that it would have to borrow funds to build a new classroom building. In the year following the acquisition of the purchase money mortgage, the school borrowed $2.5 million to finance construction of a new classroom building. Since the construction loan was reasonably foreseeable at the time the purchase money mortgage was acquired, the income from the $2 million purchase money mortgage became subject to IRC 514 effective with the time the $2.5 million was borrowed. The thought is that the school should either have required the purchaser of the old classroom building to have obtained financing from sources or, alternately, the purchase money mortgage should have been sold to help finance construction of the new classroom building. The amount of debt (acquisition indebtedness) for purposes of IRC 514 is $2 million.

Both of the above examples involve debt that was incurred soon after acquisition of the income-producing property. The sooner the debt is incurred after acquisition of property, the more likely that it was reasonably foreseeable that debt would be incurred.

In the case of partnership interests, it is clear that debt incurred by the partnership could cause an exempt organization's income from the partnership to be taxed by IRC 514. See example 4 in IRM 7751; example 4 in the regulation.

Of course, in order for there to be "acquisition indebtedness," there must be, first of all, a debt. Normally, there has been no problem identifying debt. Basically, debt is an obligation to pay a specific sum in the future. Usually, periodic payments are required so long as the debt exists; otherwise, debt would be expected to be found only when there was a lien against particular property. An important exception to this general rule is policy loans - borrowing against the cash value of an insurance policy creates a debt even though there are no consequent periodic payments or liens. (See <u>Mose & Garrison Siskin Memorial Foundation v. U.S.</u>, 603 F. Supp. 91 (E.D. D.C. Tenn. 1984), which is summarized in the Current Developments section of this CPE)

Occasionally, however, an IRC 514 case centers around the issue of whether the exempt organization involved incurred a debt. In G.C.M. 38286 (February 20, 1980) the issue was whether stock acquired and held by an IRC 501(c)(3) organization of its wholly-owned nonexempt subsidiary is "debt-financed property" where the exempt organization agreed to purchase in the future a mortgage note created between the subsidiary and a lending institution. The G.C.M. concludes the stock was not "debt-financed property" because the exempt organization had incurred no indebtedness. The subsidiary's obligation to repay the loan could not be imputed to the parent; the parent had incurred no indebtedness in purchasing the stock of the subsidiary; and purchasing the note from the bank did not constitute indebtedness because the note would be an asset, not a debt, of the parent.

Additionally, Rev. Rul. 77-72, 1977-1 C.B. 157, in discussing a rare but not unique situation, concludes that indebtedness owed to a labor union by its wholly-owned tax exempt subsidiary title-holding company resulting from a loan to pay debts incurred in acquiring two income-producing office buildings is not "acquisition indebtedness" within the meaning of IRC 514(a) because no debt was involved. The salient circumstances were (1) the union advanced the funds, from existing resources and without any borrowing; (2) the only indebtedness with respect to the acquisition or improvement of the property was that owed by the subsidiary to the union; (3) all the income from the property, less expenses, was remitted to the union; (4) the subsidiary's indebtedness to the union was represented by a demand note on which payments were made whenever the subsidiary had the available cash to do so; and (5) the books of the union and subsidiary listed the outstanding debt as "interorganizational indebtedness." In holding that this "interorganizational indebtedness" did not constitute acquisition indebtedness within the meaning of IRC 514(c), the revenue ruling concludes as follows:

> The intent of section 514 of the Code is to treat an otherwise exempt organization in the same manner as an ordinary business enterprise to the extent that the exempt organization purchases property through the use of borrowed funds. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 46 (1969), 1969-3 C.B. 200, 230. Although the subsidiary's books show an indebtedness to the union, such indebtedness is not the type contemplated under section 514. In this situation, the very nature of the title-holding company as well as the parent-subsidiary relationship show this indebtedness to be merely a

matter of accounting between the organizations rather than an indebtedness as contemplated by section 514.

There have been some private letter rulings, e.g. 8044023, on the question of whether commodity futures contracts acquired by an exempt organization constitute debt-financed property. The issue, here again, is whether indebtedness has been incurred. Favorable rulings have been issued on the basis that a commodity futures contract is merely an executory contract and does not constitute an acquisition of the underlying commodities or any incurrence of indebtedness in connection therewith. (Contrast Elliot Knitwear, supra, where the purchase of securities on margin was held to be the purchase of debt-financed property.) As cases come before us, we intend to give further study to the issue of short sales, commodity futures contracts, etc., in light of the provisions of IRC 514.

B. Special Rules

(1) Converted Property

The outstanding principal indebtedness on property is treated as acquisition indebtedness when a conversion in use of the property causes the property to be considered debt-financed. For example, a university acquired a mortgage in 1971 on an apartment building for students. Then, in 1974, the apartment building was rented to commercial tenants. Only the outstanding principal indebtedness as of 1974 became acquisition indebtedness.

(2) Failure to Retire Indebtedness

Failure to retire indebtedness on property that is not debt-financed will result in acquisition indebtedness for the unpaid balance when the property is sold and the money is used to buy other property that would have been considered to be debt-financed had it not been purchased with cash. For example, a college sold an administrative building for $1,000,000 that was subject to an outstanding debt of $400,000. Because the sale proceeds were used to purchase an unrelated business that would be considered debt-financed property had the business been financed, the former $400,000 debt balance became an acquisition indebtedness. See (41)14 of IRM 7751.

An extension, renewal, or refinancing of an obligation is also considered a continuation of the old indebtedness if the principal amount of the loan is not increased. However, an increase exceeding the original loan is treated as a separate indebtedness for purposes of IRC 514.

(3) Mortgages in General

Mortgaged property can present different problems relating to IRC 514. The general rule is that mortgaged property acquired by purchase, gift, devise, bequest, or by any other means results in acquisition indebtedness in the amount of the outstanding principal indebtedness without regard to whether the mortgaged debt was assumed by the organization. See IRC 514(c)(2). For instance, assume that an exempt organization paid $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal indebtedness was "acquisition indebtedness" just as though the organization had borrowed $100,000 to buy the property. However, Rev. Rul. 76-95, 1976-1 C.B. 172, concludes that an exempt organization that acquires an undivided interest in rental property subject to a mortgage and prepays its proportionate share of the mortgage indebtedness, receiving releases of liability from the mortgagee and co-owners, has no acquisition indebtedness even though the entire property remains encumbered by the mortgage.

(4) Mortgaged Property Acquired by Bequest, Devise or Gift

There is some relief from the "acquisition indebtedness" rules for mortgaged property acquired by bequest, devise, or gift. Mortgaged property acquired by bequest or devise is not treated as having acquisition indebtedness for 10 years after the date of the acquisition (the date the organization receives the property). Likewise, mortgaged property acquired by gift is not treated as having acquisition indebtedness for 10 years after receipt of the gift if the mortgage was more than 5 years old before the gift of the property and the property was held by the donor for more than 5 years before the gift. These exceptions, however, do not apply if the exempt organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent.

Since the exceptions do not apply if the mortgage is assumed, a question that can arise is what is meant by "subject" as opposed to "assumed." Property is owned subject to a mortgage if the liability of the owner of the property for payment of the debt is restricted to loss of the property. A mortgage is assumed if the owner of the property agrees to pay the debt irrespective of what happens to the property that is mortgaged. This becomes material if the debt is not paid and the property used to secure the debt has a value less than the amount of the debt. If the mortgage is assumed, the owner of the property is legally required to pay that portion of the debt that is not satisfied by the proceeds from the sale of the mortgaged property. Under normal circumstances, the fact that the exempt organization is making the mortgage payments is irrelevant.

(5) Other Liens

Pursuant to Reg. 1.514(c)-1(b)(2), a lien is treated as a mortgage if title to the property is encumbered by the lien for benefit of the creditor. (Examples of liens being treated as mortgages include deeds of trust, conditional sales contracts, chattel mortgages, certain security interests, pledges, agreements to hold title in escrow, and various taxes and assessments.)

Taxes and assessments of states and political subdivisions are treated as acquisition indebtedness after the amounts secured by such liens become due and the exempt organization has had an opportunity to pay the tax or assessment in accordance with state law. See IRC 514(c)(2)(C).

In explaining IRC 514(c)(2)(C), the Committee reports state that in determining when a lien becomes due and payable, and when the exempt organization has had an opportunity to pay the necessary amount in accordance with state law, consideration must be given to the realities of the situation and not merely the formal recitations of state law. For example, if a state's law provides that special assessments become due and payable at the end of a designated 30-day period, but a failure to pay the assessment at the end of that period constitutes, under state law, an election to pay the assessment in installments, for purposes of IRC 514(c)(2)(C), the assessment lien becomes due and payable only at the time when the relevant installment is required to be paid. See 1976-3 C.B. Vol. 2, pp. 428-430.

(6) Extension of Obligations (IRC 514(c)(3))

An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is considered a continuation of the old indebtedness to the extent the outstanding principal amount of the pre-existing indebtedness is not increased. Where the modified obligation exceeds the pre-existing indebtedness, the excess is treated as a separate indebtedness for purposes of IRC 514 and the regulations thereunder. See. Reg. 1.514(c)-1(c)(1).

The key here is whether the outstanding indebtedness is increased. Examples of acts which result in the extension or renewal of an obligation (as opposed to the creation of a new indebtedness) are --

(i) substitution of liens to secure an obligation;

(ii) substitution of obligees, whether or not with the consent of the organization;

(iii) renewal, extension, or acceleration of the payment terms of the obligation; and

(iv) addition, deletion, or substitution of sureties or other primary or secondary obligors.

If indebtedness is refinanced and only a portion of the refinanced indebtedness is being treated as acquisition indebtedness, payments must be apportioned <u>pro rata</u>. As an example, an organization had an outstanding principal indebtedness of $500,000 (all of which constituted acquisition indebtedness), and then borrowed another $100,000 (none of which constituted acquisition indebtedness) from the same lender, executing a $600,000 note for the total obligation. A payment of $60,000 on the total obligation would reduce the acquisition indebtedness by $50,000 and the excess indebtedness by $10,000. See Reg. 1.514(c)1(c)(3).

(7) <u>Specific Types of Obligations or Indebtedness Not Treated As Acquisition Indebtedness</u>

(a) <u>Indebtedness Incurred in Performing Exempt Purpose</u>

Under IRC 514(c)(4), acquisition indebtedness does not include an indebtedness incurred by an organization in the performance of its exempt purpose. For example, acquisition indebtedness would not include the indebtedness incurred by an exempt credit union under IRC 501(c)(14) in accepting deposits from its members or the obligations incurred in accepting payments from its members, to provide such members with insurance, retirement, or similar benefits. See Reg. 1.514(c)-1(d).

(b) <u>Annuities</u>

IRC 514(c)(5) provides that annuity obligations do not constitute indebtedness for purposes of IRC514, provided that the annuity is the sole consideration issued in exchange for property and has a value that is less than 90 percent of the property received in the exchange. A further requirement is that the annuity be paid to one or two individuals who are alive at the time of the transfer and that there be no minimum or maximum amount to be paid. For purposes of IRC 514(c)(5) the annuity to be paid cannot be adjusted by reference to the income from any property, i.e., the annuity must be a set periodic payment.

Pursuant to Reg. 1.514(c)-1(e), the value of an annuity at the time of exchange shall be computed in accordance with IRC 1011(b), Reg. 1.1101-2(e)(iii)(b)(2), and section 3 of Rev. Rul. 62-216, 1962-2 C.B. 30.

(c) Certain Federal Financing

IRC 514(c)(6) excludes certain federal financing. Obligations insured by the Federal Housing Administration are not considered to be indebtedness for purposes of IRC 514 if the obligation is to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons.

(d) Certain Lending of Securities

Pursuant to IRC 514(c)(8), if an exempt organization enters into a securities loan (as defined in IRC 512(a)(5)), there is no adverse consequence under IRC 514. An obligation to return collateral security is not treated as acquisition indebtedness. However, if an organization incurred indebtedness to purchase loaned securities, any income from such securities, including any income from the loan of the security, would be treated as debt-financed income and would be subject to tax to the extent provided in IRC 514. See (41)44 of IRM 7751.

(e) Indebtedness of Certain Educational Institutions

IRC 514(c)(9) was amended by P.L. 98-369, the Deficit Reduction Act of 1984 (DEFRA), to provide that "acquisition indebtedness" does not include indebtedness incurred after July 18, 1984, by a school (an organization described in IRC 170(b)(1)(A)(ii) and its affiliated support organizations described in IRC 509(a)) in acquiring or improving any real property. Therefore, the exception for qualified pension trusts under IRC 401, effective for taxable years beginning after December 31, 1980, now includes schools. However, in the case of schools, this exception to "acquisition indebtedness" does not apply to cases where:

(i) the price of the acquisition or improvement is not a fixed amount;

(ii) the amount of any indebtedness, or the time for making any payment, is dependent, in whole or in part, upon any revenue or income from the real property;

(iii) after the acquisition the real property is leased to the seller or related person (See IRC 267(b) or IRC 707(b) for "related person");

(iv) any person described in (iii) provides the school with financing in connection with the acquisition or improvements; or

(v) the real property is held by a partnership unless the partnership meets the requirements of (i) through (iv) and unless –

a. all the partners of the partnership are qualified organizations; and

b. each allocation (to a partner of the partnership which is a qualified organization) is a qualified allocation within the meaning of IRC 168(c)(9).

Rules similar to those in (v) shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

Sections 1034(c)(2) and (3) of DEFRA provide transitional rules for indebtedness incurred before January 1, 1985, and January 1, 1986, by certain partnerships.

(f) <u>Certain Obligations of Charitable Remainder Trusts</u>

Pursuant to Reg. 1.514(c)-1(g), for purposes of IRC 664(c) and Reg. 1.664-1(c), a charitable remainder trust does not incur "acquisition indebtedness" when the sole consideration it is required to pay in exchange for unencumbered property is an "annuity amount" or "unitrust amount" (as defined in Reg. 1.664-1(a)(1)(iii)(b) and (c)).

4. Computation of Debt-Financed Income

The unrelated debt-financed income from debt-financed property is that percentage of gross income received from the property that is proportional to the debt on the property. This is the formula:

$$\text{UNRELATED DEBT FINANCED INCOME} = \frac{\text{AVG. ACQUISITION INDEBTEDNESS}}{\text{AVG. ADJUSTED BASIS}} \text{ X } \text{GROSS INC. FROM DEBT-FINANCED PROPERTY}$$

Average acquisition indebtedness is the amount of outstanding principal indebtedness during that portion of the year the property is held. It is computed by determining the principal indebtedness of the property for the first day in each calendar month it existed and averaging all the sums. (For this computation a fraction of a month is treated as a full month.) See Reg. 1.514(a)-1(a)(3); see also (39)30 of IRM 7751.

Average adjusted basis is the average amount of the adjusted basis of the property while held by the organization. It is computed by averaging the adjusted basis of property for the first and last days of the year the organization held the property. To arrive at the proper figure for the current year, follow IRC 1011 for this computation for all appropriate years without regard to exempt status in previous years. (Depreciation must thus be computed as though the organization had been computing it in all previous years the property was held and without regard to exempt status.) See Reg. 1.514(a)-1(a)(2); see also (39)40 of IRM 7751.

The deduction allowed for debt-financed property is computed by applying the debt/basis percentage to the sum of the deductions that are directly connected to the property or its income (as in IRC Chapter 1) except that they are subject to the modification provisions in IRC 512(b). Also, the depreciation deduction permitted is computed only by the straight-line method. See Reg. 1.514(a)-1(b); See also (39)50 of IRM 7751.

Some rules relating to gains or losses from the sale or other disposition of debt-financed property need to be mentioned because any such gain or loss must be included in computing unrelated business taxable income. The amount to be included in unrelated business taxable income is the gain or loss times the percentage represented by the highest acquisition indebtedness of the property for the 12-month period before disposition, divided by the average adjusted basis of the property. See Reg. 1.514(a)-1(a)(1)(v); see also (39)22 of IRM 7751.

5. <u>Taxes on Debt-Financed Income</u>

The tax on the amount of gain (or loss) on the sale or other disposition of property includible as unrelated business income is computed according to the rules in IRC subchapter P, Chapter 1, that are ordinarily applicable to capital gains or losses. See Reg. 1.514(a)-1(a)(1)(v). Note that the computation is also applicable to a loss resulting from a sale or disposition of debt-financed property. Any part of that loss carried back or forward to another taxable year should be taken as a deduction for that year without further application of the debt/basis percentage. Likewise, any net operating loss that may have been obtained, in part, by using the debt/basis percentage computation can also be carried back or forward to other taxable years, but without further application of the debt/basis percentage. See Reg. 1.514(a)-1(a)(b)(5).